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Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1221

UNITED STATES OF AMERICA, Petitioner

v.

CONSUMER LIFE INSURANCE COMPANY, Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR CONSUMER LIFE INSURANCE COMPANY, Respondent

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BRIEF FOR CONSUMER LIFE INSURANCE COMPANY, Respondent

QUESTION PRESENTED

The question presented is whether unearned premium reserves on accident and health insurance policies which were held by an unrelated insurance company subject to the terms of valid, customary reinsurance agreements, and which were not included in respondent's reserves pursuant to applicable state law, may be attributed to respondent for the purpose of determining whether respondent qualifies as a "life insurance company" for Federal income taxation.

STATEMENT OF THE CASE

The statement of facts set forth in the Government's Brief does not adequately state the case in accord with the extensive findings of fact of the court below. Accordingly, respondent sets forth herein supplemental statements of facts based on the findings and the evidence adduced below.

From the time of its formation, Southern Discount Company ("Southern Discount"), the parent company of respondent, has been engaged in the business of consumer finance and has not been permitted by law to write insurance; respondent was therefore organized as a separate subsidiary to function as an insurance company. At the time respondent was organized, Southern Discount intended that respondent act as a reinsurer until it could qualify to write insurance directly in the states in which Southern Discount conducted business (Finding of Fact 19, App. B, Petition for Writ of Certiorari 98a (hereinafter cited as Pet. App.)). Since Arizona required smaller capital and surplus for the formation of life insurance companies than the states in which Southern Discount engaged in business, respondent was incorporated in Arizona so that it could

engage in the reinsurance business without establishing the larger capital and capital surplus that would have been necessary to be incorporated or to write insurance directly in Georgia and in the other states in question. Southern Discount was thereby enabled to employ its cash in the consumer finance business rather than in the capital of the insurance company.

Prior to the formation of respondent, Southern Discount had acted as agent for the sale of credit life and credit accident and health insurance to its borrowers and received an agent's commission on such sales; this credit insurance was written by various insurance companies (Finding of Fact 10, Pet. App. 95a). However, the commissions which Southern Discount was permitted to charge as agent were limited by law in Georgia and in other states in which it did business (Finding of Fact 12, Pet. App. 95a). Southern Discount determined for valid business reasons to enter the insurance business in order to participate to a greater degree in the profitability of the credit insurance market generated by its consumer loan business (Finding of Fact 12, Pet. App. 95a).

During the taxable years in issue, respondent was a party to two reinsurance treaties with American Bankers Life Insurance Company ("American Bankers"), an insurance company unrelated to respondent, engaged in the life and disability insurance business and organized under the laws of the State of Florida (Finding of Fact 16, Pet. App. 97a). Pursuant to the first reinsurance treaty ("Treaty I") between respondent and American Bankers dated June 19, 1957, respondent reinsured insurance written by American Bankers for customers of Southern Discount. After respondent had accumulated sufficient capital and surplus so that it

could engage directly in the writing of insurance itself, a second reinsurance treaty was entered into in 1962 ("Treaty II"), whereby American Bankers reinsured a portion of the accident and health insurance written directly by respondent. Both of these reinsurance treaties were entered into by respondent for valid business reasons and were transactions between parties dealing at arm's length (Findings of Fact 20, 21, 25 and 26, Pet. App. 98a-99a, 100a).

Reinsurance is a transaction pursuant to which an insurance company which writes insurance *transfers* for a period of time the responsibility for all or a portion of the claims that may arise under policies of insurance (Finding of Fact 18, Pet. App. 97a). This *shifting of responsibility* serves the purpose of spreading out fluctuations in exposure from claims, and the writing (or ceding) company pays the reinsurer consideration for assuming this exposure. Even if the claims experience is ultimately reflected in the cost of the reinsurance, the writing company is able to spread its liabilities or risks over a longer period of time (A. 123). The result of the reinsurance treaties with American Bankers was that respondent was not required by any applicable state laws to maintain reserves for the accident and health insurance to the extent that the accident and health insurance was reinsured pursuant to the treaties (Findings of Fact 18 and 38, Pet. App. 97a, 105a; A. 123).

In its Statement, the Government stated that "respondent therefore freely conceded in the court below (A. 130-133), that under the Treaty I arrangement, it assumed the entire insurance risk on both the credit life and the credit accident and health policies" (Brief for Petitioner at 8 (hereinafter referred to as Pet. Brief)).

The Government is in error in this regard. Respondent made no such concession in the court below, and respondent strenuously objects to such statement. The Treaty itself and the findings of the court below are clearly to the contrary and speak for themselves. The Court of Claims found that under Treaty I, "Plaintiff's obligation to reimburse American Bankers for insurance claims incurred was limited in the aggregate to the amount it received from American Bankers according to the treaty" (Finding of Fact 39, Pet. App. 105a). As to Treaty II, the court found that American Bankers' obligation to reimburse respondent for insurance claims incurred was not limited in any way (Findings of Fact 41 and 46, Pet. App. 106a, 108a).

There is no Federal insurance code affecting the industry generally. The insurance industry is regulated by the states; insurance companies are required to submit annual statements to the various state insurance commissions on a standard form developed by the National Association of Insurance Commissioners which provides information generally as to the amount of business in force, premiums received, commissions paid, the nature and amount of reserves maintained and claims experienced (Finding of Fact 49, Pet. App. 109a). Approximately every three years, an insurance company is investigated and examined by examiners employed by or working under contract to the insurance commissions of some or all of the states in which the company does business, for the purpose of ascertaining whether a company is conducting its business in compliance with state laws, regulations and procedures established primarily for the benefit of policyholders (Findings of Fact 48 and 50, Pet. App. 108a). Respondent was the subject of such examinations in 1959 and 1963, conducted by

insurance examiners from the State of Arizona (Finding of Fact 52, Pet. App. 109a). Similarly, American Bankers was the subject of a triennial examination in 1960 by the Insurance Departments of Florida, Arizona, Georgia and other states in which it conducted business (Finding of Fact 53, Pet. App. 110a).

Respondent did not establish unearned premium reserves with respect to the reinsurance of the American Bankers accident and health insurance policies under Treaty I nor with respect to the accident and health insurance ceded by respondent to American Bankers under Treaty II, nor was it required to establish such reserves by any state regulatory agency pursuant to the triennial examination or otherwise (Findings of Fact 40 and 42, Pet. App. 106a). Furthermore, the treatment of these reserves by respondent was proper from actuarial and accounting standpoints (Finding of Fact 47, Pet. App. 108a). Had respondent been required to maintain full reserves in the amount of 100% of the unearned premiums, its earnings and the consolidated earnings of Southern Discount would have been substantially reduced, with the result that Southern Discount's borrowing power would have been diminished, which would have adversely affected Southern Discount's primary business of lending (Finding of Fact 25, Pet. App. 100a). No existing state law had the effect of "attributing" to respondent any of the unearned premium reserves held by American Bankers on the insurance which was the subject of Treaties I and II (Finding of Fact 44, Pet. App. 107a).

The unearned premiums and corresponding reserves in question under Treaties I and II were both actually held by American Bankers, which received the investment income thereon, and reported by American Bankers for purposes of state regulation as well as taxation. No state regulatory agency required American Bankers, pursuant to the triennial examination or otherwise, to report the unearned premium reserves in any different fashion. Respondent did not obtain or use the unearned premiums reflected in the annual statements of American Bankers, nor were any of the said unearned premiums credited, set apart, or made available to respondent (Finding of Fact 43, Pet. App. 107a).

The Government in its Statement has referred to the testimony of its witnesses from the insurance departments of the States of Georgia and Arizona, respectively (Pet. Brief 13). Said references, it is submitted, are entirely misleading. The testimony of both of these witnesses was discredited,[1] and the court below, after con-

[1] Mr. Sturtevant testified that his background was that of an actuary for an insurance company and there was no testimony with respect to his qualifications concerning his expert status in matters relating to accounting or reinsurance of the type in issue in this case. Mr. Sturtevant testified that he completed his education in 1917 and he offered no further evidence of education or expertise with respect to matters relating to accounting for insurance companies since that date. He further testified that prior to 1960, at which time he became a special consultant following his retirement, he had no familiarity with credit life insurance (A. 236), he had never read a credit accident and health contract (A. 237), he had no personal experience with either a credit life or a credit accident and health contract (A. 237), and he had never read a reinsurance agreement dealing with credit life insurance or credit accident and health insurance (A. 237). Furthermore, he testified that prior to this case, he had never read reinsurance treaties such as the ones in issue in this case and that this was his first exposure to policies of insurance of the type in issue in this case (A. 259). He further testified that this was the first time he had ever had an opportunity to form an opinion as to the accounting and reserve treatment with respect to such policies and that this was the first time that he had ever applied accounting principles to this particular type of situation. Mr. Sturtevant stated that he had never examined such a contract until he was presented a copy of Treaty II at the time of his appearance in court in connection with this case (A. 260).

Mr. Tom Robinson, an examiner for the State of Arizona De-

sidering the testimony, rejected it in reaching its Findings of Fact.[2]

SUMMARY OF ARGUMENT

I.

Congress has devised a simple test by which an insurance company may determine whether it is a life insurance company and therefore in what fashion it will be required to pay income taxes. This test has remained virtually unchanged since the statute was enacted in 1921, and is currently located in Section 801(a) of the

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partment of Insurance, testified that Treaty II, in his opinion, was a surplus aid contract. Mr. Robinson further testified that he presented his position to the Director of Insurance for the Department of Insurance of Arizona in person and that he analyzed Treaty II in his presence (A. 266). Mr. Robinson's further testimony on cross-examination was that "so far as my efforts in respect to these contracts, it was almost an effort in futility. . . . Well, so far as I know, no result ever came from it" (A. 272). Thus, the Arizona Department of Insurance was not in agreement with the opinions of Mr. Robinson notwithstanding the fact that Mr. Robinson discussed the question carefully and in person with the head of the Arizona Insurance Department. Mr. Robinson further stated that at a later time he became the Assistant and Acting Director, and still did not take action with respect to this matter. Mr. Robinson testified clearly that the Department of Insurance of the State of Arizona examined both respondent and American Bankers, and that the examination would have included a careful analysis of the reinsurance treaties, and the State of Arizona did not require respondent to establish reserves on the accident and health reinsurance that was the subject of Treaty II.

[2] With respect to its conclusion that Georgia law did not require respondent to maintain the reserves in question, the Court of Claims stated:

> Finally, with relation to the testimony of Mr. Sturtevant, who testified that the unearned premium reserve as reported by American Bankers and Plaintiff was permitted 'unwittingly' by the Georgia Insurance authorities, we have reviewed his testimony and it does not change our interpretation of the Georgia law above expressed [Pet. App. 91a].

Internal Revenue Code of 1954. If an insurance company holds life insurance reserves in an amount which constitutes more than fifty percent of the total reserves which it holds, the company qualifies as a life insurance company and is taxed accordingly.

In the present case there is no dispute as to the amount of life insurance reserves held and reported by respondent. The question in this case is whether, as the Commissioner of Internal Revenue claimed, the total reserves held by respondent should have included certain unearned premium reserves on accident and health insurance which were not held by respondent, but in fact were held and reported by American Bankers, an unrelated life insurance company with which respondent had entered into certain reinsurance treaties. The Court of Claims held that said reserves could not be attributed to respondent and that respondent therefore qualified as a life insurance company.

The Commissioner did not attempt to attribute the unearned premium reserves to respondent by virtue of sections 269 or 482 of the Internal Revenue Code, which by their terms specifically provide for attribution or reallocation of certain funds among related parties, since the prerequisites for application of those sections of the Code did not exist in respondent's case. The Commissioner claimed, rather, and the Government contends in this appeal, that respondent remained liable on the risks to which the accident and health insurance in question pertained, and therefore should have established the reserves therefor, or at least that those reserves should be attributed to respondent. This contention is made in spite of the fact that the statute in question makes no reference whatsoever to risk as a

test for qualification, and the legislative history of the statute and its forerunners, as well as the courts which have considered the question, confirm the fact that the reserve requirements for insurance companies are to be established by the states and not indirectly through its taxing power by the Federal government. The states which had authority over the conduct of respondent's business regularly examined that business and specifically the sufficiency of the reserves maintained therefor, and on more than one occasion approved the arrangements now brought into question.

A misinterpretation of the distinctions between insurance risk and the risk of not making a profit has led the Government to state that respondent conceded that it bore the ultimate insurance risk on the policies in question. In fact, respondent shared, to the extent of premiums received by respondent, the expense of the claims under the accident and health insurance and could have conceivably been prevented from realizing any profit thereon. Respondent's liability, however, was limited under the treaties at issue in this case to the premiums paid, and could never have exceeded those premiums nor resulted in an economic loss to respondent, since American Bankers bore the true insurance risk in each case and was subject to no limitations. Regardless of who bore the risk (and perhaps in fact, as this case illustrates, because of the difficulty of determining in any case who does bear the risk, or a given share thereof) no statute or regulation exists which suggests that incidence of risk determines the attribution of reserves for purposes of life insurance company qualification. The Government's theory is unsupportable and without any authoritative precedent. To attempt

to impose such a test upon an industry where reinsurance is the norm and most risks are shared to some degree among companies would result in chaos. Indeed the Commissioner's own regulations, in an effort to provide certainty in this field, require that before a reserve may be claimed by or charged against a party, that reserve must be both actually held by it and reported on its annual statements. The Government has not, in the entire history of this case, suggested any reason why the Commissioner must not be held to the requirements of his own regulations on this matter.

II.

Respondent was formed, and entered into the business of credit insurance, in an effort to increase the profitability of its parent company's consumer finance business through providing insurance to its parent's borrowers. Respondent was formed in a state which required lower capital and surplus for insurance companies than most other states, and earned sufficient income through its initial business of reinsurance (which did not require qualification in other states) and accumulated enough capital to qualify to write insurance directly in the states in which its parent company conducted business.

Respondent's insurance business, both as a reinsurer and later as the writing company, was composed of both life insurance and accident and health insurance. The reserves required for this insurance were maintained by either respondent or American Bankers, the other party to respondent's reinsurance treaties, in accordance with the requirements of the state insurance authorities and the terms of those treaties. The reserves required as to accident and health insurance tradition-

ally consist of the entire unearned premium paid for said insurance, and those reserves diminish as the premiums become earned. Initially, those reserves constitute a substantial economic burden, and respondent contracted in both reinsurance treaties for American Bankers to maintain those reserves. American Bankers was a much larger company and was able to absorb the accident and health reserves without unduly restricting its financial condition. Also, because of this reinsurance arrangement, respondent qualified as a life insurance company for purposes of Federal income taxation.

The arrangements between respondent and American Bankers were reached as a result of arms length bargaining between unrelated parties. The reinsurance treaties were entered into for substantial non-tax as well as tax purposes, and they resulted in appreciable non-tax consequences. They were carefully reviewed by the state authorities who regulate the insurance industry, and no suggestion was made, either to respondent or American Bankers, that the maintenance of unearned premium reserves by American Bankers was improper or unlawful.

The insurance treaties, and maintenance of reserves thereby required, were lawful and proper. These business arrangements are entitled to recognition for Federal income tax purposes to the same extent that they were recognized and approved for non-tax purposes.

ARGUMENT

I. UNEARNED PREMIUM RESERVES ESTABLISHED BY AN UNRELATED INSURANCE COMPANY IN ACCORDANCE WITH APPLICABLE STATE LAW AND INSURANCE INDUSTRY ACCOUNTING AND ACTUARIAL PRACTICES MAY NOT BE ATTRIBUTED TO RESPONDENT'S "TOTAL RESERVES" FOR PURPOSES OF DETERMINING WHETHER RESPONDENT QUALIFIES AS A "LIFE INSURANCE COMPANY."

A. Respondent Qualifies as a Life Insurance Company Based upon the Express Statutory Test of Section 801 of the Internal Revenue Code of 1954.

The present statutory scheme for the Federal income taxation of insurance companies divides insurance companies into three basic groups. The first group consists of life insurance companies taxable pursuant to section 802 of the Code; the second group consists of mutual insurance companies (other than life insurance companies) taxable pursuant to section 821 of the Code; and the third group consists of insurance companies (other than life or mutual companies) taxable pursuant to section 831 of the Code. The ultimate question in the instant case is whether respondent is to be taxed as a life insurance company in accord with section 802 or as an insurance company other than a life company pursuant to section 831.

The definition of a life insurance company is set forth in section 801 of the Code, which provides a test measured in terms of life insurance reserves. That test requires that at least fifty percent of the total insurance reserves which a company holds must consist of life insurance reserves. Section 801(a) provides:

> [T]he term 'life insurance company' means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance) . . . if
>
> (1) its life insurance reserves (as defined in subsection (b)), plus
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in subsection (c)).

Life insurance reserves as defined by Section 801(b) are amounts which are computed or estimated on the basis of recognized mortality tables and assumed rates of interest and which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance and annuity contracts and certain noncancellable health and accident insurance contracts; and, in addition, reserves must be required by law except in certain circumstances not pertinent here.

The term "total reserves" is defined in Section 801(c) as meaning:

> (1) life insurance reserves,
>
> (2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and
>
> (3) all other insurance reserves required by law.

The issue presented in this case is whether the unearned premium reserves held by American Bankers with respect to the accident and health policies in question are includible in respondent's "total reserves" (as defined in section 801(c)) for purposes of the reserve

ratio test prescribed by section 801(a). It is respondent's position that the unearned premium reserves established and held by American Bankers, a company which was unrelated to respondent, are not includible in respondent's total reserves for the purposes of the reserve ratio test. Respondent submits that the reserves in question are not "attributable" to respondent as the Government maintains and, therefore, respondent should qualify as a life insurance company as that term is defined in section 801(a) of the Code. The Government's position appears to be that "a company's eligibility for life insurance company status necessarily turns on whether it in fact assumes life insurance risks" (Pet. Brief 45), and "that the reserves must be attributed to the company that actually assumes the insurance risk" (Pet. Brief 48).[3] Respondent respectfully disagrees with these assertions in that such tests are clearly contrary to the express language of section 801 and the legislative intent thereof and seek to measure life insurance company status by a vague Federally imposed yardstick for determining reserves which, in itself, is contrary to the clearly expressed Congressional intent that state law will control in matters relating to insurance companies.

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[3] The Government has cited *Helvering v. LeGierse*, 312 U.S. 531 (1941) as authority for the proposition that the essence of insurance is risk-shifting. Such a statement was indeed made in that case. The case, however, dealt with the question of whether insurance proceeds were to be included in a decedent's gross estate. It is submitted that this case constitutes no precedent for any issue now before the Court.

The reserve ratio test has been expressed by the Court of Claims in *Alinco Life Ins. Co. v. United States*, 373 F.2d 336, 350 (Ct. Cl. 1967) in terms of the following table:

Qualifying reserves (numerator)	÷	Total reserves (denominator)
1. Tabular reserves on life, annuity, and noncancellable accident and health policies		1. Tabular reserves on life, annuity, and noncancellable accident and health policies
2. Unearned premiums on noncancellable life, health, or accident policies not included in (1)		2. Unearned premiums not included in (1)
3. Unpaid losses on noncancellable life, health, or accident policies not included in (1)		3. Unpaid losses not included in (1)
		4. All other insurance reserves required by law.

The first attempt at defining a life insurance company for the purposes of Federal income tax laws occurred in the Revenue Act of 1921 which first accorded special tax status to life insurance companies. Section 242 of that Act defined a life insurance company as one which is:

> engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

While the statutory definition was modified somewhat in the Revenue Act of 1942, the reserve ratio test was preserved for purposes of defining a "life insurance company." [4] The present reserve ratio test of section 801(a) of the Internal Revenue Code of 1954 is essentially the same as that originally enacted in 1942 as section 201(a) of the 1939 Code.[5] Thus, the reserve ratio test as originally enacted in 1921 and modified in 1942 has been based throughout this entire period upon a ratio of life insurance reserves compared with "total reserve funds" and since 1921 that ratio has continued to be fifty percent for the purposes of the qualification formula.

The question of what constitutes "reserve funds" has been the subject of substantial attention over the years. Several early cases considered the question of the meaning of the term "reserve funds required by law" [6] in the context of whether such reserves were deductible in determining the net income of the insurance companies involved. These cases generally held that such reserve funds had a technical meaning in the tax law and did not, for instance, include amounts held against unpaid losses, and that "the term reserve funds has

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[4] The 1942 Act, however, did go further to define total reserves as meaning "life insurance reserves, unearned premiums and unpaid losses not included in life insurance reserves, and all other insurance reserves required by law." Int. Rev. Code of 1939, §201(a).

[5] Senate Report No. 291 of the Senate Finance Committee on the Life Insurance Company Income Tax Act of 1959, 1959 U. S. Code Cong. & Ad. News 1575, 1616.

[6] Section 12(a) of the Revenue Act of 1916, 39 Stat. 756, permitted deductions from gross income of, "in the case of insurance companies, the net addition, if any, required by law to be made within the year to reserve funds. . . ." Thus, these cases deal principally with the question of deductions from income.

reference 'to the funds ordinarily held as against the contingent liability on outstanding policies.' " *McCoach v. Ins. Co. of North America*, 244 U.S. 585, 589 (1917); *see also Ocean Accident and Guarantee Corp. v. Commissioner*, 47 F.2d 582, 584 (2d Cir. 1931) and cases cited therein. The Internal Revenue Service ruled under the Revenue Acts of 1913 and 1918 that reserve funds required by law included not only reserves required by express statutory provisions but also included reserves required by the rules and regulations of the state insurance departments. L.O. 1104, I-II Cum. Bull. 331 (1918).

In discussing the derivation of the term "reserve fund" as used in the various Revenue Acts, one authority on Federal income taxation states:

> It was not clear whether the term "reserve fund" as used meant assets held to provide for a liability or whether it meant the stated liability itself without regard to whether the company has reserved sufficient assets to provide for it. The term "fund" as used by laymen generally signifies money or the equivalent—hence assets. But actuaries use the terms "reserve" and "reserve fund" synonymously and frequently to express not money or the equivalent but a liability for which money is needed. And the provisions of the Code which deal with life insurance companies were drafted by and with the assistance of actuaries for taxpayers who are accustomed to actuarial language. . . .
>
> The term "reserve fund" appears to have been derived from the term "fund" used in the schedules of the Life Assurance Companies Act of 1870, and the Assurance Companies Act of 1909, acts passed by the English Parliament for the control of insurance companies, where the term "fund" was used to express the company's reserve liability

> under its policies which it was required to report on the liability side of the schedules. . . .
>
> * * *
>
> The question of whether the term "reserve fund" as used meant a liability or meant assets held for a liability was sometimes of importance, e.g., Pilot Life Ins. Co., 9 BTA 980, where a reserve deduction was allowed only to the extent of the assets held and not to the extent of the full liability. . . . 8 Mertens *Law of Federal Income Taxation* §44.26, n. 1 at 73 (1970).

The Government asserts that the fundamental error committed by the court below was that it confused the concept of "unearned premium reserves" with the unearned premiums themselves (Pet. Brief 16). "Unearned premiums" are defined in the regulations as those amounts which cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Treas. Reg. § 1.801-3(e). The regulations further provide that unearned premiums "must have been actually held during the taxable year." Treas. Reg. §1.801-4(a). Contrary to the Government's assertion of fundamental error, respondent finds no confusion between unearned premiums, on the one hand, and unearned premium reserves, on the other, in the court's conclusions. The court below, throughout its findings, recognized the preciseness of the terminology involved. For example, the court found that the unearned premium reserve for accident and health insurance is 100% of the gross premium at the outset of the policy term, (Finding of Fact 36, Pet. App. 104a); and that the unearned portion of the premium "is set aside on the books and records of the Company as the unearned premium reserve" (Finding of Fact 32, Pet. App. 103).

The court further recognized that as the policy expires with the passage of time, the premium becomes "earned" to the extent of the expiration, because the earned portion was paid for coverage which had been provided during the expired portion of the policy. *Id.* Thus the Court of Claims concluded that an unearned premium reserve measures an insurance company's reserve requirements by looking to premiums already paid by policyholders and then determining the portion of said premiums that represent payment for insurance to be provided after the reserve valuation date (Finding of Fact 33, Pet. App. 103a). The court also made findings to the effect that the unearned premiums in this case were physically held by American Bankers (Finding of Fact 43, Pet. App. 107a). Based on the foregoing findings by the court below, respondent submits that the Government's contention is erroneous, and that the court used the term in the correct technical sense relying on the evidence adduced at trial.

Furthermore, in the present case the applicable state law and accounting practice in the insurance industry demonstrate that there is no reason to distinguish between unearned premiums and unearned premium reserves. Both the Arizona and Georgia insurance laws set forth reserve requirements for casualty insurance in terms of unearned premiums. Ariz. Rev. Stat. Ann. §20-506; Ga. Code Ann. §56-906. Also, it is standard in insurance accounting that the company which possesses the unearned premiums is the only company required to maintain the reserves thereon (Finding of Fact 47, Pet. App. 108a; A. 118-19). For accounting purposes it seems clear that the party which holds the unearned premiums must establish the reserves since, as a matter

of accounting, the "asset" which consists of premiums received must be offset by a "liability," which could be either reserves or surplus. Where there are no assets, there can similarly be no offsetting reserves or surplus without adjusting some other liability account. In the present situation, respondent had no guarantee that it would receive any amounts from American Bankers, and whenever they were received, they would no longer be "unearned" in the respondent's hands. Therefore it would have been improper for respondent to have established an unearned premium reserve for unearned premiums which it did not hold nor had any right to receive, and could not therefore have claimed as an asset. It is proper, therefore, for the party with the asset to establish the liability. That Congress used the phrase "unearned premiums" establishes that Congress was aware of prevailing state law and insurance industry accounting practices in this regard and that said term is used in its technical sense.

B. State Law is Centrally and Expressly Involved in the Definition of a Life Insurance Company for Purposes of the Internal Revenue Code.

Insurance companies have always looked to the laws of the various states in which they are engaged in business for rules and regulations as to the types and amounts of reserves required for their business purposes (Finding of Fact 48, Pet. App. 108a). The states have long exercised regulatory control over the insurance industry because of the obvious public interest in maintaining solvent insurers. Congress, rather than attempt to impose Federal standards for the definition of reserves in the Federal income tax laws, has consistently

left the establishment of said standards to the various states.

In recognition of this Congressional intent, decisions of this Court confirm the central and express importance of state law requirements relating to "reserves" or "reserve funds" as those terms are used for Federal income tax purposes with regard to insurance companies, both life and non-life. In *Brown v. Helvering*, 291 U.S. 193, 201 (1934), this Court stated:

> [T]he deductions allowed for additions to the reserves of insurance companies are technical in character and are specifically provided for in the Revenue Acts. These technical reserves are required to be made by the insurance laws of several states.

The importance of state law requirements with regard to the qualification of reserves as "life insurance reserves" under the reserve-ratio test has been illustrated in more recent cases such as *Mutual Benefit Life Ins. Co. v. Commissioner*, 488 F.2d 1101, 1105-06 (3rd Cir. 1974); *Drummond Citizens Ins. Co. v. United States*, 298 F. Supp. 692, 697-98 (E.D. Ark. 1969), *aff'd*, 427 F.2d 1163 (8th Cir. 1970); and *Lamana-Panno-Fallo Industrial Ins. Co. v. Commissioner*, 127 F.2d 56 (5th Cir. 1942).

This Congressional intent to rely upon state law for the substantive regulation of the insurance industry is the keystone of insurance company taxation, and provides an element of certainty upon which companies may rely in determining their tax liabilities. As stated in Denny, Rua and Schoen, *Federal Income Taxation of Insurance Companies* (2d ed. 1966) at 5-9,

> Congress has left to the states the determination of the amounts which must be reserved by insurance companies to provide for their liability to policyholders under the various types of contracts written.

During the hearings in connection with the Life Insurance Company Income Tax Act of 1959, Representative Curtis of Missouri said:

> I think we can easily write a tax code if we determine that we are going to regulate the industry at the Federal level. I have resisted that to date because I do not think it is to the good of our society . . . . Committee Print of Hearings Held November 17-20, 1958, Before Subcommittee on Internal Revenue Taxation, Committee on Ways and Means, U.S. House of Representatives, 85th Cong., 2d Sess., 1958.

The propriety of the Government's use of Section 801 as a means of regulating the insurance industry at the Federal level was discussed in great detail by the Court of Claims in its decision in *Alinco Life Ins. Co. v. United States*, 373 F.2d 336 (Ct. Cl. 1967). The court there stated:

> The Government's presentation of its case against Alinco has been flavored with moral and regulatory overtones. Such a sensitive concern for good business morals should not be for the Treasury. . . .
>
> Insofar as regulation is concerned, it is of course true that Congress frequently employs a taxing statute to achieve a non-fiscal or regulatory goal. Where, however, there is a Congressional intent to connect a regulatory objective to a revenue raising measure, the legislative history will always disclose that intent either directly or indirectly. See *United States v. Kahriger*, 345 U.S. 22, 27 (1953).

The Congressional intent is obvious from an examination of the Code itself. Subsections (b) and (c) of section 801, in defining life insurance reserves and total reserves, refer explicitly to reserves "required by law" unless specifically excepted. The exceptions have no bearing on this case, but the need for their existence is further illustration of the reliance of the Code upon state law requirements.[7] That the law referred to is state law is clear from the absence of Federal law as to requirements for insurance reserves and the explanation in the Treasury Regulations that the laws in question are those of the States, Territories and District of Columbia, and any lawful regulations issued pursuant thereto. Treas. Regs. §§1.801-4(a) and 1.801-5(a). The reason for such reference to and reliance upon reserves required by law is apparently to eliminate the possibility of manipulation of reserves, upon which not only qualification but the amount of tax is based (since reserves constitute an offset against income pursuant to sections 809 and 810 of the Code), while permitting arrangements for valid business purposes which satisfy the comprehensive state requirements.

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[7] The importance of state law to the scheme of taxation of life insurance companies is also clear from the many references thereto in the Code and Treasury Regulations. The legislative history concerning the exclusion of deficiency reserves from life insurance reserves for purposes of the reserve ratio test illustrates the central importance of state law requirements to the definition of a life insurance company. In discussing the statutory language which excluded deficiency reserves for these purposes, the Senate Report accompanying the Life Insurance Company Income Tax Act of 1959 stated that "the effect of this language . . . is to exclude deficiency reserves both from life insurance reserves and total reserves, *even though such deficiency reserves are required by State law.*" Senate Report No. 291, 1959 U.S. Code Cong. & Ad. News 1575, 1617. (emphasis added).

C. The Respondent Was Not Required by Applicable State Law to Maintain the Unearned Premium Reserves on the Accident and Health Policies Subject to the Reinsurance Treaties in Question.

Pursuant to the terms of respondent's initial contract with American Bankers ("Treaty I"), American Bankers ceded to respondent all of the credit life and credit accident and health insurance which it wrote on the customers of Southern Discount. The liabilities of respondent pursuant to the terms of Treaty I "followed" the liabilities of American Bankers, except that the liability of respondent as to the credit accident and health insurance was on an "as earned" basis whereas the liability of respondent as to the credit life insurance was on an "as written" basis.[8] The effect of this difference in the type of reinsurance provided was that respondent received the entire premium on the credit life insurance as that insurance was written by American Bankers, and respondent was obligated to reimburse American Bankers for all credit life insurance claims paid by American Bankers during the course of the treaty. There was no limitation to respondent's liability as to said credit life insurance. As to the credit accident and health insurance, however, respondent received premiums from American Bankers only as they became "earned" each month. Under the terms of the treaty, respondent's liability to reimburse American Bankers for claims paid on the credit accident and health insurance was limited to the amount of earned premiums it

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[8] When premiums have been paid for coverage to be provided in the future, they are deemed "unearned;" as time passes, a portion of the premium becomes "earned," according to any one of a number of methods of computation, until the coverage expires, at which time the entire premium has been "earned."

had received from American Bankers, or was carried over as a charge against premiums as they became earned in the future, and could not, by virtue of Articles I and V of said Treaty I (Pet. App. 26a and 29a-30a), ever exceed the total amount of payments made by American Bankers to respondent.

Pursuant to Article VI of Treaty I (Pet. App. 30a), respondent maintained all reserves required for the credit life insurance covered by the treaty (for which it had received from American Bankers all premiums at the outset, as written), and American Bankers owned, established and maintained all "unearned premiums, loss and other reserves as may be required by law" for the credit accident and health policies as to which American Bankers had retained the premiums until such time as they became "earned."

When respondent had qualified to write insurance directly in certain states in which Southern Discount did business, by 1962, it entered into a second treaty ("Treaty II") pursuant to which respondent, as the primary insurer, ceded to American Bankers eighty percent of its credit accident and health insurance (later sixty-five percent), but did not reinsure the credit life insurance. The reinsurance of credit accident and health insurance according to the terms of Treaty II was on an "as written," as opposed to an "as earned" basis, and respondent ceded to American Bankers all of the premiums on that portion of the insurance subject to the treaty at the time written, and American Bankers established the unearned premium reserves for said insurance which were required by law. Also, as provided by the laws of Arizona and Georgia, respondent took credit, for reserves held by American

Bankers, against the reserves which would otherwise have been required by virtue of its acting as direct writer for this insurance. There was no limitation to the liability which American Bankers assumed under this treaty; it was obligated to reimburse respondent in the full amount of claims paid by respondent to its policyholders. There was, furthermore, an experience refund provision in the treaty, which provided that if the reinsured business was profitable American Bankers would refund to respondent the profit resulting from premiums received in excess of claims and expenses for commissions incurred, after an allocation of three percent of the gross premium to American Bankers.

The applicable Arizona law concerning reserves is found in §20-506 of the Arizona insurance code:

> A. With reference to insurance against loss or damage to property, except as provided in §20-507, and with reference to all general casualty insurance, disability insurance, except as provided in §§20-508 and 20-510 [not in point here], and surety insurance, every insurer shall maintain an unearned premium reserve on all policies in force.
>
> B. The director may require that such reserves be equal to the unearned portions of the gross premiums in force *after deducting reinsurance in solvent insurers* as computed on each respective risk from the policy's date of issue. [emphasis added].

Georgia Code Ann. §56-906 contains a substantially identical provision.

The Arizona law imposes its requirement for unearned premium reserves on insurers as policies come in force, and provides a credit for insurance ceded to a solvent reinsurer, against this reserve requirement.

Thus under Arizona law respondent had no liability for reserves under Treaty I, since as to respondent said reinsurance was not in force until the premiums had become earned, and under Treaty II respondent received full credit for reinsurance ceded to American Bankers, and was required to maintain no unearned premium reserves on the ceded portion.

The Government argues, however, that in view of the definition of assets in the Arizona and Georgia insurance laws,[9] an insurance company is required to establish reserves upon its assumption of the risk without regard to its actual receipt of the corresponding premiums. The Government's reliance on state statutes defining assets is misplaced. The purpose of defining assets (and liabilities) is related to determining the financial condition of a company and insuring that company's solvency. Contrary to the Government's assertion, the statutory definition of assets is not broadly drawn; rather, it is drawn in restrictive terms to insure that an insurance company does not overstate its assets.[10]

The specific sections of the Arizona and Georgia insurance laws defining assets neither require, nor permit, respondent to include in its assets the unearned premiums held by American Bankers. Assets "in the course of collection . . . not more than three months past due," Ga. Code Ann. §56-901(6) and Ariz. Rev. Stat. Ann. §20-501(5), cannot apply to the unearned premiums held by American Bankers nor to the earned

[9] Ariz. Rev. Stat. Ann. §20-501; Ga. Code Ann. §56-901.

[10] Thus, Ga. Code Ann. §56-901 states:

> In any determination of the financial condition of an insurer, there shall be *allowed* as assets *only such assets* as are owned by the insurer and which consist of . . . ." (emphasis added).

premiums to which respondent had a contractual right, since respondent had no right to the *unearned premiums*, and the *earned premiums* were not then due. Similarly, the definition of assets as "amounts receivable by an assuming insurer representing funds withheld by a solvent ceding insurer under a reinsurance treaty," Ga. Code Ann. §56-901(10) and Ariz. Rev. Stat. Ann. §20-501(9), is inapplicable since the earned premiums were not withheld from respondent, and the unearned premiums did not constitute an amount receivable by respondent. As was held by the court below,

> [Those] sections . . . refer to amounts already due and unpaid. The definition of assets . . . refers to items in the possession of the taxpayer or to which the taxpayer has an enforceable claim. Without including the unearned premium in taxpayer's assets, there can be no unearned premium reserve charged against that item [Pet. App. 83a].

The Government also refers to Ga. Code Ann. §56-901(8) and Ariz. Rev. Stat. Ann. §20-501(7), defining assets to include "notes and like written obligations not past due, taken for premiums other than life insurance premiums, on policies permitted to be issued on such basis, to the extent of the unearned premium reserves carried thereon." This provision has no application to the unearned premiums held by American Bankers or the earned premiums to which respondent had a contractual right. The asset is clearly allowable only if there is an unearned premium reserve maintained by the party claiming the asset. The Government turns the statute around, arguing that since there is an asset, therefore, there must be an unearned premium reserve. But even assuming that respondent's

contractual right to earned premiums constituted a "note or like written obligation," respondent's right was to earned premiums only, and, accordingly, respondent would not have established an unearned premium reserve therefor. Unearned premiums do not automatically become earned; if the insurance is cancelled by the policyholder, the unearned portion must be returned, and will never become earned.

The fallacy in the Government's argument is its assumption that American Bankers, like a bank, merely held the unearned premiums. In fact, American Bankers not only held the unearned premiums, it had a contractual right to them and received the investment income therefrom. Respondent had a right to the premiums as and if they became earned; it had no right to the unearned premiums, and under the terms of the applicable Arizona and Georgia insurance laws, was not required to maintain reserves for these unearned premiums.

The Court of Appeals for the Seventh Circuit in *Economy Finance Corp. v. United States*, 501 F.2d 466, 478 (7th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975), *rehearing denied*, 421 U.S. 922 (1975), Motion for Leave to File a Second and Untimely Petition for Rehearing, *pending*, No. 74-701, likened the reserves held by the reinsurer in that case to bank deposits, but the facts in *Economy* are clearly distinguishable from the facts in the instant case. In *Economy*, the court found that the unrelated reinsurer invested said reserve funds in debentures of the finance company and paid over the interest from these debentures, as additional commissions, to a family owned insurance agency comprised of the principal stockholders of the finance company. Unlike American Bankers in the instant case, that unrelated reinsurer merely served as a conduit for the return of said reserves to the related group of companies, and did not even retain the investment income generated thereby. Such facts would clearly indicate that this was indeed more akin to a mere deposit arrangement and is totally distinguishable from the facts in the present case, where the Court of Claims found that respondent did not obtain or use the unearned premiums, "nor were said unearned premiums credited, set apart, or made available" to respondent (Finding of Fact 43, Pet. App. 107a).

Apparently recognizing that respondent was not required by the express language of the Arizona and Georgia insurance laws to maintain reserves on unearned premiums held by American Bankers, the Government asserts that both the Arizona and Georgia insurance laws are based upon the proposition that insurance reserves should follow the insurance risk. The Government's argument proceeds that, since respondent allegedly bore the ultimate insurance risk on the accident and health policies, respondent was required by state law to establish the reserves therefor, even though respondent did not hold the unearned premiums. The Government bases its argument upon its interpretation of the requirements of Arizona and Georgia insurance laws. Insofar as the Government relies on the Arizona and Georgia insurance laws' definitions of assets discussed above, respondent submits that there is absolutely nothing contained therein which supports the theory that insurance reserves follow the insurance risk. The provisions of the Arizona and Georgia insurance statutes which are relevant to a determination of the respective states' unearned premium reserve re-

quirements[11] are not even cited by the Government, and in fact furnish no support for its theory. Nor has the Government been able to cite any judicial or administrative decision supporting its theory.

If there is any doubt as to the construction to be placed upon the Georgia and Arizona insurance laws respecting reserves for unearned premiums, the actions of the respective Georgia and Arizona insurance regulatory agencies are conclusive evidence that respondent was not required by state law to maintain reserves for the unearned premiums held by American Bankers. In the present situation, both the Arizona and Georgia insurance laws provided for enforcement of these laws by the state regulatory agencies. Under Ariz. Rev. Stat. Ann. §20-152 the director of insurance was empowered to certify the facts of any violation to the attorney general for enjoining the violation. Similarly, in Georgia, the Commissioner of Insurance had authority under Ga. Code Ann. §56-214 to institute legal proceedings for the enforcement of any provision of the Act. As found by the Court of Claims, "for the years in question, none of these actions were taken by either of the state offices in charge" (Pet. App. 88a).

In its holding below the Court of Claims emphasized the generally accepted principle that where a statute is ambiguous or doubtful, and in the absence of judicial authority to the contrary, it is generally accepted that the uniform and consistent interpretation of that statute by the regulatory body charged with administration thereof is entitled to great weight (Pet. App. 88a). This principle was clearly set forth in *Salt Lake County v.*

[11] Ariz. Rev. Stat. Ann. §20-506; Ga. Code Ann. §56-906.

Kennecott Copper Corp., 163 F.2d 484, 489 (10th Cir. 1947), *cert. denied*, 333 U.S. 832 (1948), where the Court of Appeals adopted a state administrative agency's interpretation of an ambiguous state statute. *See also Traveler's Indemnity Co. v. Wells*, 316 F.2d 770, 773 (4th Cir. 1963).

This principle has been approved by this Court, on numerous occasions, in cases involving interpretation of Federal statutes by Federal administrative agencies. *Norwegian Nitrogen Products Co. v. United States*, 288 U.S. 294, 358 (1933); *Trafficante v. Metropolitan Life Ins. Co.*, 409 U.S. 205, 210 (1972); *Griggs v. Duke Power Co.*, 401 U.S. 424, 433-34 (1971); and *Robertson v. Dowling*, 127 U.S. 607, 613 (1888). Both the Georgia and Arizona Supreme Courts would apply the same principle. *See e.g., Chee Lee v. Superior Court*, 81 Ariz. 142, 302 P.2d 529 (1956) and *Thompson v. Eastern Air Lines, Inc.*, 200 Ga. 216, 36 S.E.2d 675 (1946). The cases cited by the Government, *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967); *King v. Order of United Commercial Travelers of America*, 333 U.S. 153 (1948); and *West v. A. T. & T. Co.*, 311 U.S. 223 (1940), although involving a somewhat different issue, are consistent with the rule established by the decision in *Salt Lake County v. Kennecott Copper Corp., supra*, and further support the conclusion that the actions of the Arizona and Georgia insurance agencies are determinative in this case as to the reserve requirements of the state insurance laws.

The actual rule established by the cases cited by the Government is that "an intermediate appellate state court * * * is a datum for ascertaining State law which is not lightly to be disregarded by a federal court *unless*

it is convinced by other persuasive data that the highest court of the state would decide otherwise." Estate of Bosch, supra, at 465. The Government has failed to indicate that "other persuasive data" exists which would convince a Federal court that the highest courts of the states of Arizona and Georgia would have adopted a construction of the Arizona and Georgia insurance laws different from that applied by the regulatory agencies in question. The Government has failed to cite a single state court decision or administrative rule or regulation supporting its construction of the Arizona or Georgia insurance laws. The very absence of any Arizona or Georgia state court decisions in this area demonstrates the importance of administrative agency interpretations in interpreting and enforcing state law provisions with respect to required reserves. The decision in *King v. Order of United Commercial Travelers of America, supra,* illustrates the rule stated above. In that case, this Court concluded that an intermediate state court decision was not binding on Federal courts because decisions of that intermediate state court were not binding on any other state courts. But in the present case, the interpretation of the insurance laws by the administrative agencies charged with their enforcement would be accorded great weight by the highest courts of the states of Arizona and Georgia. *See e.g., Chee Lee v. Superior Court, supra* at 33, and *Thompson v. Eastern Air Lines, Inc., supra* at 33.

The Government suggests that the uniformly consistent approval of respondent's and American Bankers' method of handling the unearned premium reserves by the Georgia and Arizona administrative agencies should be of no import, in the case of Georgia, because the chief Georgia insurance examiner testified that the agency's

action was done "unwittingly" and contrary to state policy. Similarly, in the case of Arizona, the Arizona examiner testified that respondent should have been required to maintain the reserves under Treaty II, but had been permitted to exclude the reserves because it was the first time that the Arizona Insurance Commissioner had encountered that type of arrangement. *See* discussion, *supra* at 7, note 1.

The Georgia examiner conceded that he was not familiar with the type of reinsurance treaties in question (A. 235-36 and 259-60) and was confused about the requirement of statutory law. Therefore his opinion concerning administrative practice is entitled to no weight. In fact, it is apparent that the chief examiner confused the reinsurance treaties in question with surplus aid contracts, which they plainly are not.[12] The Georgia examiner was not even employed by the Georgia Insurance Department during the years

[12] The Government contended in the court below that the reinsurance treaties in question were "surplus aid contracts," relying upon excerpts from the National Association of Insurance Commissioners, Examiners Handbook (3rd rev. ed. 1970) and testimony of the Arizona and Georgia examiners. (The Examiners Handbook was not admitted as evidence in this case because there was no evidence demonstrating that the Georgia or Arizona insurance departments used the Handbook for the tax years in question.) The surplus aid contracts referred to by the Government do not remotely resemble respondent's Treaty II, particularly in the one element which constitutes "surplus aid." That element is the existence of a "tentative" or "contingent" commission, paid at the outset to the ceding company but subject to repayment by the ceding company to the reinsurer in the event losses suffered by the reinsurer exceed an agreed-upon amount. This is the heart of the concept of illegitimate "surplus aid"—the existence of an amount of money credited initially to the ceding company and claimed by it as surplus capital, but which may be recalled by the reinsurer. It is obvious that the approach of the National Association of Insurance Commissioners, in refusing credit to the ceding company for a reserve held by the reinsurer on *this portion* (and this portion only) of the

in issue in this case and had no involvement in the examination of respondent. Since the reinsurance treaties in question were the first of this type that the Georgia examiner had seen, it is obvious that he was not qualified to testify as to what the policy of the Georgia Insurance Commissioner would be or should have been with respect to the reinsurance treaties in question.

The Arizona examiner's testimony is rendered meaningless by his confusion of these treaties with those

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total reserves required, has no application to respondent, which neither received nor took credit for any such "tentative commissions." Repondent's surplus could not have been affected by the negative carry-forward provision of the treaty which the Government finds so objectionable, since there was no requirement that respondent ever repay the negative amount out of claimed surplus (or any other source); rather, the carry-forward could only be set off against future payments due to respondent, and then only for a limited period of time. It should be noted that the reserve required on the "tentative commissions," if any, must be maintained by the party to the contract (the ceding company) who in fact *holds the premium dollars* on this portion, as respondent contends is the proper treatment. The difference between the "surplus aid contract" and respondent's Treaty II was carefully depicted on Plaintiff's Exhibit 27: "Comparison of Agreement Types" (A. 404).

Respondent received an experience refund from American Bankers, based on the profitability of the business ceded. This type of arrangement is described in the portion of the Handbook directly following the description of "surplus aid contracts" entitled "Ordinary 'Sliding Scale' Contracts." The first portion of that description reads thus:

> A large proportion of reinsurance business is written on a "sliding scale" or "profit commission" basis, so that if the ceded business is profitable, the ceding company will receive additional commissions from the reinsurer. There is no criticism of this provision, with the understanding no credit shall be taken for such contingent commission until the loss ratio has actually been developed and the additional commission, if any, has thus been earned.

As illustrated in Exhibit 27, no credit for surplus was taken by respondent for the experience refund, or additional commission, until it had in fact been earned.

which are known as surplus aid contracts (A. 265 and 269), but more importantly, whatever the examiner's views, they were specifically rejected by the Arizona Insurance Commissioner (A. 272-73).

The Government's reliance upon the testimony of the Arizona and Georgia insurance examiners is totally misplaced, since the fact remains that the formal and official acts of the administrative agencies of Georgia and Arizona were totally inconsistent with the testimony of those two witnesses. It is clear that the insurance departments of both states approved respondent's and American Bankers' method of handling the unearned premium reserves after thorough examinations and specific consideration of these treaties.

Respondent, for the tax years in question, was not required by state law, statutory or as administered, to maintain reserves on the unearned premiums in question. As Treas. Reg. §1.801-5 provides:

> (b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

The Government has failed to identify any express statutory provision, or any rule or regulation of the appropriate insurance department, which required respondent to maintain reserves on the unearned premiums

held by American Bankers, and accordingly no such reserves can be attributed to respondent for purposes of the definition of a "life insurance company" within the meaning of section 801(a) of the Code.

II. THE REINSURANCE TREATIES BETWEEN THE RESPONDENT AND AMERICAN BANKERS HAD APPRECIABLE ECONOMIC SUBSTANCE AND WERE ENTERED INTO FOR VALID BUSINESS PURPOSES.

The Government has argued in its brief that decisions of this Court involving assignment of income principles and lack of economic substance should be applicable to the case at bar. It is respectfully submitted that the cases relied upon do not support the Government's contentions and that the principles set forth in these cases should have no application to the case at bar.

A. Assignment of Income Principles Are Not Applicable to this Case.

The court below found as a fact that both reinsurance treaties between the respondent and American Bankers were entered into for valid business reasons by unrelated parties dealing at arms' length (Finding of Fact 21, Pet. App. 99a). Furthermore, the court found that, at all times, the unearned premiums and corresponding reserves in question were physically held and maintained by American Bankers, which received the investment income thereon and reported said reserves for purposes of state regulation as well as taxation (Finding of Fact 43, Pet. App. 107a). The court below also found, and the evidence is clear and uncontroverted to this effect, that the treatment of these reserves by the state insurance regulatory authorities of all the states

involved, with respect to both respondent and American Bankers, was entirely consistent with respondent's treatment of said reserves. Thus, based on these facts the question presented is whether a situation involving two unrelated parties dealing at arms' length, who enter into a business transaction for valid business purposes and who treat the transaction in a manner in accordance with state law and acceptable to state insurance regulatory authorities, can be said to be lacking in economic substance or reality so as to be disregarded for purposes of the income tax laws. Respondent submits that the cases cited by the Government dictate a negative response and that these cases do not support the Government's contentions.

Respondent recognizes that in cases dealing with closely related parties this Court has developed the doctrine that income will be taxed to the one who earns it, and that anticipatory assignments to shift that income to another party will be disregarded for tax purposes. However, that doctrine should not be applicable to the instant case because it deals solely with the taxation of *income* to a party other than the party which in fact receives the income. That is clearly not the question before this Court.[13]

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[13] The Government has suggested that the case of *Commissioner v. Hansen*, 360 U.S. 446 (1959), is at least analogous to the case at bar (Pet. Brief 57). The *Hansen* case dealt not with the question of ownership of assets or state regulation, but with a specific statute (Section 42 of the 1939 Code) pertaining to rules of accrual accounting. The question raised in *Hansen* was when income should be recognized by a taxpayer using the accrual method of accounting and is totally inapplicable to the question of whether assets such as unearned premiums (or the liability account for reserves), may be attributed from one to another unrelated taxpayer. In *Hansen* the Court found that the taxpayer had a fixed right to receive the income in question. Respondent finds the analogy of

The cases relied upon by the Government do not support the proposition that insurance reserves may be attributed or reallocated to parties not in possession thereof in the same manner that income may be. In *Lucas v. Earl*, 281 U.S. 111 (1930), it was held that the statute in question taxed salaries to those who earned them, and a husband who earned salaries and fees could not escape income taxation on them by entering into a contract vesting the salaries and fees in his wife. Similarly, in *Helvering v. Horst*, 311 U.S. 112 (1940), it was held that one could not escape tax by making a gift of detachable bond interest coupons in advance of the payment of interest; and in *Corliss v. Bowers*, 281 U.S. 376 (1930), it was held that when a donor retained control over trust property the donor remained taxable on the income although it was paid to the donee. In *United States v. Basye*, 410 U.S. 441 (1973), also cited by the Government, the partners of a medical partnership were held to have received compensation with respect to payments that were paid into a retirement trust for the benefit of the partners of the medical partnership pursuant to the terms of a written agreement. As this Court pointed out in the *Horst* case:

> Underlying the reasoning in cases like *Helvering v. Clifford*, 309 U.S. 331 (1940), is the thought that income is 'realized' by the assignor because he, who owns or controls the source of the income, also

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the *Hansen* case to the present case difficult to comprehend because in the instant case there is no question concerning the accrual of income, which is governed by specific statutory provisions inapplicable to this case. Furthermore, even as to respondent's right to these assets, respondent had no fixed right to receive the unearned premiums, which were subject, at any time prior to becoming earned, to be returned to the policyholder upon cancellation of the policy, as, for example, when the customer's debt was prepaid.

> controls the disposition of that *which he could have received himself* and diverts the payment from himself to others as the means of procuring the satisfaction of his wants . . . whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. 311 U.S. at 116-17 [emphasis added].

It is submitted that the Government's reliance on these cases and others similar to them is entirely misplaced because in the present case we have two unrelated parties, each of which was regulated by state law; each performed its respective functions, which it was licensed to perform, pursuant to reinsurance treaties which provided for independent consideration for the responsibilities of each thereunder. Neither party sought to "vest" income *or* reserves in another in a manner inconsistent with its responsibilities under state law or the treaties, but, quite to the contrary, each party conducted its business affairs and maintained its financial accounts completely in accordance with state law. These circumstances do not warrant the same conclusions or the adoption of a rationale similar to that which was followed in the *Horst* case. In *Horst* the Court raised the question "whether because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment." 311 U.S. at 116. In answering its question the Court cited *Burnet v. Wells*, 289 U.S. 670 (1933) and held that the exercise of the power "to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it." 311 U.S. at 118.

One need only point to the decision of this Court in *Commissioner v. First Security Bank*, 405 U.S. 394 (1972) as authority for the inapplicability of the *Lucas* and *Horst* cases, and others cited, to the instant case. In *First Security Bank* this Court held "that the Commissioner could not properly allocate any income to one of a controlled group of corporations under 26 U.S.C. §482 where that corporation could not have received that income as a matter of law." *United States v. Basye*, 410 U.S. at 454, n. 13 (1973). The facts in *First Security Bank* involved a business plan substantially identical to that which as was utilized in the cases pending in the present consolidated cases, wherein a bank holding company organized an Arizona life insurance company for the purpose of reinsuring credit insurance written by other unrelated insurance companies including, coincidentally, American Bankers, with respect to customers of a bank subsidiary of the holding company. In *First Security Bank* the Government sought to reallocate the income of the life insurance company to the bank subsidiary pursuant to the authority of section 482 of the Internal Revenue Code. This Court was faced with resolving conflicting decisions in *Local Finance Corp. v. Commissioner*, 48 T.C. 773 (1969), *aff'd*, 407 F.2d 629 (7th Cir. 1969), *cert. denied* 396 U.S. 956 (1969) and the decision of the lower court in *First Security Bank*, 26 T.C.M. 1320, *rev'd*, 436 F.2d 1192 (10th Cir. 1971). In both cases the Tax Court had held against the taxpayer, basing its decisions on the rationale developed in *Lucas v. Earl, supra*, and *Helvering v. Horst, supra*. In the *First Security Bank* case, the Court of Appeals for the Tenth Circuit and this Court differed with the conclusions of the Tax Court. The Tenth Circuit decision stated:

> Generation of income differs from assignment of income. It is fundamental that the taxpayer cannot assign a portion of his income in order to avoid tax liability on it. . . . Also the power to dispose of income is the equivalent of ownership. . . . These principles are grounded on rights in or flowing from income. 436 F.2d at 1197.

In affirming the Tenth Circuit this Court stated:

> We know of no decision of this Court wherein a person has been found to have taxable income which he did not receive and that he was prohibited from receiving.
>
> . . . [T]he assignment-of-income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another. 405 U.S. at 403-04.

Since the Commissioner would not have had the power to assign income under the general principles of section 61 of the Internal Revenue Code, *First Security Bank* denied the Commissioner the power to allocate the income under section 482. In the present consolidated cases the Commissioner seeks again to apply the same theories that were rejected by this Court in *First Security Bank* and the same conclusion should be reached in these cases.

Respondent respectfully submits that assignment of income principles are not applicable to situations involving unrelated parties dealing at arms' length in transactions that are consistent in all respects with state law and, in addition, with general accounting and actuarial principles applicable to the particular industry involved.

B. The Reinsurance Transactions Between Respondent and American Bankers Possessed Appreciable Economic Effect.

In asserting that the reinsurance transactions between the respondent and American Bankers lacked economic substance and are therefore to be ignored for Federal tax purposes, the Government has relied on a legal theory and cases which, it is submitted, are not applicable to the case before this Court. The case of *Gregory v. Helvering*, 69 F.2d 809 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935), is the touchstone for the Government's argument, but respondent believes that the doctrine of the *Gregory* case, as further developed by subsequent cases, is inapplicable to the case at bar. In the *Gregory* case, a corporation and its sole stockholder attempted to accomplish through the form of a statutory corporate reorganization a transaction which had no other purpose apart from tax motives. Judge Hand speaking for the Court of Appeals for the Second Circuit held that the transaction did not meet the test of a reorganization because "the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham. . . ." 69 F.2d at 811. This Court, while recognizing the legal right of a taxpayer to decrease or avoid taxes altogether by means which the law permits, affirmed the Second Circuit's decision and found that the reorganization was but "an operation having no business or corporate purposes—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character. . . ." 293 U.S. at 469. Thus, this Court held that the sole object was to consummate a preconceived plan to transfer to the sole stockholder shares of stock in another corporation and not to reorganize a business,

and that this effort should not be recognized for Federal income tax purposes.

In analyzing this Court's decision in *Gregory* and the subsequent cases of *Griffiths v. Helvering*, 308 U.S. 355 (1939); *Higgins v. Smith*, 308 U.S. 473 (1940); and *Bazley v. Commissioner*, 331 U.S. 737 (1947), Judge Hand concluded in the context of a later case that these cases in no way intimate that a transaction should be disregarded even where a taxpayer's only motive is to minimize taxes, or to reduce taxes; but, rather, the doctrine of those decisions "covers *only those transactions that do not appreciably change the taxpayer's financial position*, either beneficially or detrimentally." *Gilbert v. Commissioner*, 248 F.2d 399, 410-12 (2d Cir. 1957), (dissenting opinion) (emphasis added). Judge Hand further suggested that an appreciable change in a taxpayer's financial position should be the determining test, and not the fact of whether the transaction "has substantial economic reality" or "is a 'sham' or a 'masquerade' or 'depends upon the substance of the transaction.' " *Gilbert v. Commissioner, supra* at 411. Judge Hand stated:

> If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose.

The test proposed by Judge Hand in his dissent in the *Gilbert* case was recognized with approval in *Knetsch v. United States*, 364 U.S. 361, 366 (1960). There the taxpayer entered into an annuity transaction with an unrelated insurance company pursuant to which the taxpayer claimed large interest deductions. This Court

held that the taxpayer's transactions with the insurance company did not "appreciably affect his beneficial interest except to reduce his tax." *Id.* In *Knetsch* this Court further stated "it was patent there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." *Id.*[14]

Based on the test of appreciable change in the taxpayer's financial position as developed by the *Knetsch* case and the *Gilbert* dissent, it would seem that a business transaction must be recognized for tax purposes if the transaction is treated consistently for material *non-tax* purposes. *See,* Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance,* 77 Yale L.J. 440, 462-64 (1968). Conversely, a transaction does not appreciably change the taxpayer's financial position either beneficially or detrimentally when it involves no part of the conduct of the business of the participants. The result, therefore, should be that if the transaction in question has appreciable non-tax consequences then consistent treatment must be accorded for tax purposes. This test is consistent with the decision in *Knetsch,* where this Court concluded that the transaction should be ignored for tax purposes since it had no economic purpose apart from tax savings and, indeed, except for taxes, resulted in a substantial economic loss.

The "appreciable effect" test as developed by Judge Hand in his dissenting opinion in *Gilbert, supra,* and by

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[14] The dissenting opinion in *Knetsch* would have recognized the annuity transaction for tax purposes even if only to achieve a tax deduction "as long as the transaction itself is not hocus-pocus," and pointed out that these transactions were real and legitimate in the insurance world, emphasizing, as respondent does elsewhere in this brief, the importance of regulatory action by authorized bodies concerning commercial transactions.

this Court in *Knetsch, supra,* is even more applicable to a business transaction in situations where, as in the case at bar, the non-tax consequences include a specific recognition of the transaction by state regulatory authorities with respect to both parties to the transaction. The principle has long been recognized that state law controls "when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law." *See, Burnet v. Harmel,* 287 U.S. 103, 110 (1932). Thus, in a situation such as the case at bar, where Federal tax law has clearly looked to the respective state insurance laws and to the state regulatory agencies, the fact that the entire reinsurance transaction was accorded the treatment for state regulatory purposes which the parties themselves gave it should be given considerable weight and, it is submitted, should constitute conclusive and binding authority in determining whether the "appreciable effect" test is met for purposes of applying the Federal tax laws.

In the present case the entire thrust of the Government's position with respect to the economic substance argument is contrary to the *Knetsch* and *Gilbert* dissent test, since the Government argues that the transaction should not be recognized for tax purposes notwithstanding that it was so recognized for non-tax purposes and particularly for state regulatory purposes. The findings of the court below clearly support the respondent's argument that there were "appreciable" non-tax consequences flowing from the transaction.[15] Since the

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[15] It should also be noted that there was a recognition of business purpose by this Court in the *First Security Bank* case, *supra* at 42, in a situation involving similar transactions.

transaction had a business purpose for each of the unrelated participants, which was recognized by the appropriate regulatory authorities, the following language of Judge Hand has particular application:

> In construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation. *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949).

Applying the "appreciable effect" test to the instant case, both respondent and American Bankers were in a position, as a result of the reinsurance treaties, by which their respective financial positions could be affected, either beneficially or detrimentally. American Bankers assumed responsibility for paying for claims for which it received a consideration and respondent relieved itself from obligations to establish and maintain substantial reserves which would have adversely affected its relative capital and surplus position. Respondent furthermore gained the advantage of deferring or spreading out the risk from potential claims. It is respectfully submitted, therefore, that the 'appreciable effect" test clearly has been met in the present case.

C. Tax Minimization Motives Are to Be Disregarded in Judging the Reinsurance Transaction.

Respondent readily concedes that an aspect of the reinsurance treaties between respondent and American Bankers was the qualification of respondent as a life insurance company for purposes of deferring a portion of its taxes. However, the decisions of this Court are

well settled that "a taxpayer's motive is irrelevant in determining his liability." *Loewi v. Ryan*, 229 F.2d 627, 629 (2d Cir. 1956). In that case the court said:

> [W]e hold that the Act is to be interpreted against its own background, and in deciding how far it adopted all legal transactions that the state law may have covered, [referring to the transaction in *Gregory v. Helvering*] it was proper to exclude those that had no other result than to evade taxation. The purpose of the Act was to exempt from tax only such legal transactions as arose out of an enterprise or venture that had some other authentic object of its own, and were neither alien and hostile to the raising of revenue, nor designed to effect no change in legal interests except to defeat a tax. *Id.* at 629.

In *Kraft Foods Company v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), the Court of Appeals for the Second Circuit reaffirmed its holding in the *Loewi* case and specifically raised the question "[a]ssuming, then, that the purpose of the transaction was to minimize taxes, should the transaction be disregarded because of its tax motivation?" *Id.* at 127. The Commissioner argued that such transactions should be disregarded if they have no purpose other than tax minimization. The Second Circuit rejected the Commissioner's argument and held:

> We do not think that these cases hold that tax minimization is an improper objective of corporate management; they hold that transactions, even though real, may be disregarded if they are sham or masquerade or if they take place between taxable entities which have no real existence. The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact. *Id.* at 128.

Respondent's business purpose was not to evade or defeat a tax but to minimize its tax by legally permissible means while conducting its business in the most profitable manner legally allowable. To accomplish this respondent determined to enter into legal arrangements providing for reinsurance whereby an unrelated party would share the insurance risk, in consideration of an agreed upon amount and the right to earn income from the investment of its reserves.

It is respectfully submitted that the reinsurance transactions pursuant to Treaty I and Treaty II comply with the "appreciable effect" test as previously adopted by this Court and the Treaties should be recognized for tax purposes, and that respondent's motive to minimize its taxes by legally permissible means does not detract from the conclusion that the reinsurance treaties appreciably affected the financial positions of both respondent and American Bankers.

CONCLUSION

For the reasons stated, the judgment of the Court of Claims in No. 75-1221 should be affirmed.

Respectfully submitted,

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